

COMMENTS

Approaching the Limits of the Bankruptcy Code: Does Surcharging a Debtor's Exempt Assets Go Too Far?

Amanda K. Bloch[†]

INTRODUCTION

American bankruptcy law developed as a means to benefit both insolvent debtors and their unsatisfied creditors. Since an insolvent debtor typically owes more to creditors than there are assets for distribution, a bankruptcy proceeding encourages both sides to work together in dividing up the available assets instead of allowing a potentially destructive race to the courthouse.¹ However, in addition to its role in overcoming the collective action problem among creditors, the Bankruptcy Code was enacted in order to provide debtors, unable to pay their debts, with a “fresh start.” This fresh start is accomplished by distributing estate property to creditors and thereafter relieving the debtor of any further obligations (referred to as a “discharge” of debt).² In order to operate properly, however, bankruptcy proceedings require the parties to follow the stringent regulations set forth in the Code; otherwise, the delicate balance between creditors’ and debtors’ interests may be disturbed.

The Bankruptcy Code includes important provisions intended to provide debtors with a suitable standard of living during and after the bankruptcy proceeding. An individual debtor filing for bankruptcy is permitted to exempt a number of assets from the bankruptcy estate, which the creditors may not reach, in order to allow the debtor to be-

[†] BA 2007, Emory University; JD Candidate 2010, The University of Chicago Law School.

¹ See Thomas H. Jackson, *The Logic and Limits of Bankruptcy* 9 (Harvard 1986) (comparing the competition among creditors for a debtor’s assets to buying tickets for a rock concert, where the people first in line get the best seats while the people in back may get nothing at all).

² Thomas Jackson, in discussing the “fresh start” policy in bankruptcy law, explains,

[A]n individual who resorts to bankruptcy can obtain a discharge from most of his existing debts in exchange for surrendering either his existing nonexempt assets, or more recently, a portion of his future earnings. Discharge not only releases the debtor from past financial obligations, but also protects him from some of the adverse consequences that might otherwise result from that release.

Id at 225.

gin a “fresh start” with an adequate quality of life.³ Once a creditor accepts a debtor’s list of exempt assets, those assets are considered exempt under the Bankruptcy Code. Sometimes, however, debtors attempt to retain property that should be distributed to creditors by improperly concealing or refusing to turn over nonexempt assets that belong to the bankruptcy estate. If the creditors uncover the assets, the court will order the debtor to turn them over. However, if the debtor consumes the nonexempt assets after filing for bankruptcy (in lieu of using his exempt assets) the creditors may no longer be able to reach those assets to satisfy their claims.⁴ Therefore, the debtor would retain more property than he is permitted under exemption statutes, but his creditors would not be able to reach the nonexempt property because it no longer exists. In these situations, the Code authorizes the court to impose sanctions on debtors or to provide remedies for the wronged creditors. For instance, the court may refuse to discharge a debt, issue an order to turn over property, or even dismiss the case.⁵ One circuit court and several district courts have additionally allowed courts to use their equitable powers, granted in 11 USC § 105(a),⁶ to “surcharge”⁷ a debtor’s exempt assets in order to compensate for the nonexempt assets improperly hidden or retained by the debtor.⁸ Creditors in these cases surcharge, or reach, a debtor’s exempt assets and extract the value of the nonexempt estate property.

The Tenth Circuit recently challenged this approach in *In re Scrivner*,⁹ where the court performed a statutory analysis of the Code and held that courts may not use their equitable powers to surcharge a debtor’s exempt assets under any circumstances. *Scrivner* thus created a split between the Tenth Circuit and other courts, including the Ninth Circuit, which set forth the prevailing view that bankruptcy courts

³ See *id.* at 231.

⁴ For example, this may occur where a debtor conceals his interest in a corporation and uses the corporation’s assets. See Part II for cases involving this fact pattern.

⁵ See Part I.D.

⁶ Section 105 provides a bankruptcy court the power to “issue any order, process or judgment that is necessary to or appropriate to carry out the provisions” of the Bankruptcy Code. 11 USC § 105. For a discussion of 11 USC § 105(a), see Part I.C.

⁷ According to Black’s Law Dictionary, a “surcharge” means: “The amount that a court may charge a fiduciary that has breached its duty.” See *In re Hamblen*, 354 BR 322 (Bankr ND Ga 2006) (“In exceptional circumstances, bankruptcy courts have the authority to fashion a remedy that allows a trustee to surcharge or *offset* an exemption.”) (emphasis added).

⁸ See Part II.A.

⁹ 535 F3d 1258, 1265 (10th Cir 2008) (holding that § 105(a) can only be invoked to further a substantive provision of the code, and not to help create a new substantive right).

may use their equitable powers under § 105(a) to allow creditors to surcharge a debtor's exempt assets.¹⁰

The main force driving the *Scrivner* court's decision was its statutory interpretation of the Code coupled with an analysis of the court's equitable powers.¹¹ In particular, the court held that § 105(a) may only be invoked to further a substantive provision of the Code, and allowing creditors to surcharge a debtor's exempt assets exceeds that power because it is not connected to a substantive provision of the Code.¹² As the court noted, it is beyond a bankruptcy court's equitable powers to create a substantive right,¹³ and therefore courts may not create a right that allows creditors to surcharge a debtor's exempt assets.¹⁴ This Comment argues that *Scrivner* is correct, and that § 105(a) does not authorize the power that courts have used to try and repair the perceived injustice of debtors retaining more assets than the law allows. The courts that have used § 105(a) to surcharge a debtor's exempt assets do not further a specific provision of the Code, and thus treat § 105(a) as a substantive rather than procedural instrument. This extends the court's authority beyond its statutory limit and thus, as the *Scrivner* court recognized, should not be permitted.

However, there is another power granted to bankruptcy courts that allows them to achieve the same outcome without resorting to an expansion of the court's statutory authority: the court's power to hold a party in civil contempt.¹⁵ A bankruptcy court may use its civil contempt powers to fashion sanctions that compensate a harmed party, coerce a party in contempt to comply with the court's orders, or both. A bankruptcy court's contempt powers are broad discretionary grants of power that arise regardless of whether the law underlying the court order stems from bankruptcy law or nonbankruptcy law.¹⁶ Unlike § 105(a), the court's contempt powers need not be connected to a specific provision of the Bankruptcy Code.

This Comment therefore sets forth a novel approach to situations where a debtor violates a court order by refusing to disclose or turn

¹⁰ See *Latman v Burdette*, 366 F3d 774, 782 (9th Cir 2004).

¹¹ See 535 F3d at 1265.

¹² *Id.*

¹³ In this Comment, the terms "right" and "remedy" are used interchangeably to refer to surcharges. This reflects the fact that the Ninth Circuit speaks mostly in terms of remedies while the Tenth Circuit speaks mostly in terms of rights. Accordingly, the terms are both used throughout this Comment and are not intended to convey different meanings.

¹⁴ *Scrivner*, 535 F3d at 1265.

¹⁵ *Id.* at 1265 n 3.

¹⁶ See Part III.B.2.

over assets: courts should be able to use their contempt powers to surcharge that debtor's exempt assets. While a court would exceed its equitable powers under § 105(a) by creating the substantive right to surcharge a debtor's exempt assets at its discretion, the court may accomplish the same outcome by holding a debtor in contempt of court by reaching that debtor's exempt assets and retrieving the value of the improperly retained property. However, this Comment argues that the power to hold a debtor in contempt should be limited to those circumstances where the debtor's behavior displays a gross deviation from proper conduct. Specifically, this Comment proposes that the contempt power should be limited by three minimum requirements. In order to invoke this power to surcharge, courts should be required to find that (1) the debtor willfully violated a court order, (2) the debtor received the full value of his permitted exemptions after filing the bankruptcy petition, and (3) the creditor is unable to obtain the non-exempt estate property.

Providing courts with this remedy serves several purposes that coincide with the purposes of the Code. First, and most importantly, it compensates an aggrieved creditor where other available remedies are not as helpful. Additionally, it coerces the debtor to comply with court orders, further deters debtors from fraudulently concealing or retaining estate property, thus preserving court resources, and provides legitimacy to the bankruptcy process.

This Comment is divided into three Parts. Part I provides a background on bankruptcy proceedings and relevant provisions of the Code, specifically focusing on exemption laws, a court's equitable powers, and remedies for fraud in the bankruptcy process. Part II discusses the split in the courts regarding whether a creditor may surcharge a debtor's exempt assets. Part III presents an analysis of the issue and sets forth a solution to the dispute: where a debtor violates a court order to disclose or turn over estate property, the court should be able to hold that debtor in contempt of court and surcharge his exempt assets. Allowing courts to sanction debtors under these circumstances compensates the creditor and enforces the purposes of the provisions of the Bankruptcy Code without causing the courts to exceed the limits of their equitable powers or violate any provisions of the Code.

I. BACKGROUND ON BANKRUPTCY PROCEEDINGS AND THE BANKRUPTCY CODE

This Part provides a historical background on the Bankruptcy Code and delves into bankruptcy provisions that are relevant to this Comment. In particular, it discusses a bankruptcy court's history as an

equitable court, both bankruptcy and nonbankruptcy exemption laws, a court's equitable powers pursuant to § 105(a), and various remedies available to bankruptcy courts where a party perpetuates a fraud during the proceedings.

A. The Origin of the Bankruptcy Code

American bankruptcy courts are “essentially” courts of equity.¹⁷ The Supreme Court in *Pepper v Litton*¹⁸ explained the inherent powers that bankruptcy courts, as courts in equity, are authorized to employ: “In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.”¹⁹ Bankruptcy courts have subsequently applied their inherent powers to numerous situations in order to administer the bankruptcy estate and proceedings.²⁰

Although bankruptcy courts are considered courts in equity, they are also governed by the Bankruptcy Code and are subject to the limitations of their statutory power.²¹ Congress is authorized, under the United States Constitution, to enact laws that govern the administration and process of a bankruptcy system,²² and Congress has done so several times.²³ For example, in 1978, Congress passed the Bankruptcy Reform Act, codified in Title 11 of the United States Code, known as

¹⁷ See *Pepper v Litton*, 308 US 295, 304 (1939) (noting that “a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the [Bankruptcy] Act, it applies the principles and rules of equity jurisprudence”); *Local Loan Co v Hunt*, 292 US 234, 240 (1934) (claiming that bankruptcy courts are constituted by §§ 1–2 of the Bankruptcy Act and are invested “with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings”).

¹⁸ 308 US 295 (1939).

¹⁹ *Id.* at 308.

²⁰ See Alan N. Resnick and Harry J. Sommer, eds, 2 *Collier on Bankruptcy* ¶ 105.04 at 105-58 (Matthew Bender 15th rev ed 2009) (“Courts have used these provisions of section 105 to resolve issues regarding the ability to detect and punish contempt, to regulate the practice of lawyers, to administer the assets under its control and the claims related to them, and to monitor and supervise all bankruptcy estates.”).

²¹ See Barry E. Adler, Douglas G. Baird, and Thomas H. Jackson, *Cases, Problems, and Materials on Bankruptcy* 47 (Foundation Press 2007) (explaining that, under 28 USC § 1334 and 28 USC § 157(a), bankruptcy courts are mere adjuncts of the district courts and therefore do not exercise independent judicial power).

²² US Const Art I, § 8, cl 4 (“The Congress shall have the power to . . . establish . . . uniform laws on the subject of bankruptcies throughout the United States.”).

²³ See Jackson, *Logic and Limits* at 1 (cited in note 1) (describing the history of bankruptcy law in the United States, from the constant enactments and repeals of bankruptcy statutes in the 1800s to the evolution of the more stable Bankruptcy Code in 1978).

the Bankruptcy Code.²⁴ United States bankruptcy courts are district courts in the federal system, and the courts employ both federal and state laws. While the Bankruptcy Code governs the bankruptcy procedure, state laws are often applied to various aspects of the process, and these state laws are nonbankruptcy law.²⁵

There are two main purposes of the Bankruptcy Code. First, the Code purports to provide individual debtors with a fresh start, so they may live their lives free of debt following the bankruptcy proceedings.²⁶ Courts achieve this by first dividing a debtor's existing nonexempt assets (the estate property) between his creditors, and then by granting the debtor a discharge of any remaining debt.²⁷ Upon discharge, the debtor is released from his prior obligations to the debtor and is able to begin his life with a fresh start. In addition, the Code is designed to facilitate orderly debt collection.²⁸ It equitably distributes a debtor's assets in order to pay creditors as much of the debt owed to them as possible. This process thereby prevents creditors from racing to the courthouse and incurring additional costs (such as continuous oversight of the debtor and separate litigation). Therefore, the overriding purpose of the bankruptcy system is to benefit both debtors and creditors by (1) discharging the debtor's remaining debts so he may proceed in his life without overwhelming monetary obligations, and (2) providing creditors with some of the debt owed to them by an insolvent debtor.²⁹ In order to achieve these two goals, the Code provides courts with the authority to strictly regulate the process so as to prevent abuse of the system.³⁰

B. Exemption Laws

Individual debtors filing for bankruptcy are permitted to exempt a number of assets from their estate and thus prevent creditors from

²⁴ See Douglas G. Baird, *Elements of Bankruptcy* 6 (Foundation Press 2006).

²⁵ See *id.* at 5.

²⁶ See *Marrama v Citizens Bank of Massachusetts*, 549 US 365, 367 (2007); *Local Loan Co.*, 292 US at 244.

²⁷ See Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at the Incentives under U.S. Bankruptcy Law and a Proposal for Change*, 65 U Chi L Rev 685, 687–88 (1998).

²⁸ See Jackson, *Logic and Limits* at 3 (cited in note 1) (“Bankruptcy law, at its core, is debt-collection law.”).

²⁹ See *id.* at 4 (noting that the dual concerns of bankruptcy must also be balanced with other considerations, including the notion of open access to credit markets).

³⁰ See, for example, 11 USC § 522 (governing the procedures required to exempt property), 11 USC § 541 (defining the property of the estate), 11 USC § 547 (allowing courts to set aside preferences), 11 USC § 727 (regarding discharge of debt).

reaching the assets.³¹ In the Bankruptcy Code, 11 USC § 522 governs the process of exempting property from the bankruptcy estate.³² The justification for allowing debtors to retain a certain amount of property is based on providing that debtor with a fresh start following the bankruptcy proceeding.³³ When Congress enacted § 522, it noted that “[t]he historical purpose of these exemption laws has been to protect a debtor from his creditors, to provide him with the basic necessities of life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge.”³⁴ Therefore, exemption statutes are protective measures that Congress intended both for an individual debtor’s benefit as well as for the public good.

Exemption statutes vary greatly across states and between the federal-state level, and the scope of a debtor’s permitted exemptions often depends on the governing law. Depending on the applicable law, debtors are frequently able to exempt their homestead, automobile, and certain personal assets. Under federal law, for example, § 522(d) provides that debtors may exempt, up to a specified amount, their interest in real property used as a residence, a motor vehicle, household furnishings, jewelry, medical equipment and supplies, certain insurance policies, and more.³⁵ Additionally, the federal bankruptcy exemption laws provide debtors with a “wild card” exemption—a stipulated value of assets that debtors may exempt from their estate.³⁶ But § 522 also enumerates specific exceptions stipulating assets that debtors may not exempt. For example, § 522(c) identifies certain debts that may not be exempted and § 522(k) identifies administrative payments that may not be exempted.³⁷

However, state law, as opposed to federal law, often determines the scope of a debtor’s exempt property. The Bankruptcy Code contains a federal alternative whereby debtors are permitted to choose whether they will follow the federal exemptions listed in the Code, pursuant to

³¹ See Resnick and Sommer, 4 *Collier on Bankruptcy* ¶ 5.22.01 at 522-16–16.1 (cited in note 20) (noting that the Bankruptcy Code both provides the debtor with a list of exemptions and allows him to take advantage of more liberal state exemptions, if applicable).

³² 11 USC § 522.

³³ See *In re Gould*, 389 BR 105, 113 (Bankr ND Cal 2008).

³⁴ HR Rep No 95-595, 95th Cong, 1st Sess 126 (1977), reprinted in 1978 USCCAN 5963, 6087.

³⁵ See generally 11 USC § 522(d). Section 522 is the lengthy statute that specifically enumerates what can be counted as an exempt asset in bankruptcy proceedings. It also includes rules for determining exempt assets and even lists assets that cannot be considered exempt, being so specific as even to note that artworks are not exempt, unless they are of or by the debtor or a relative. 11 USC § 522 (f)(4)(B)(i).

³⁶ See 11 USC § 522(d)(5).

³⁷ 11 USC § 522(c); 11 USC § 522(k) (listing, for example, debts secured by tax liens and administrative expenses of avoiding a transfer as nonexempt).

§ 522(d), or their state exemption rules.³⁸ Most states, though, have opted out of the federal alternative, pursuant to 11 USC § 522(b)(1),³⁹ and instead put forth their own laws governing exemptions.⁴⁰ In these states, debtors are required to follow the state exemption laws and the non-Code federal exemption laws.⁴¹ It is important to note that state exemption laws, while they may apply to bankruptcy proceedings, are in fact nonbankruptcy exemption laws—they prevent creditors from reaching those assets both inside and outside of bankruptcy.⁴²

In order to exempt property, debtors are required to file a list of exempt property pursuant to Federal Rule of Bankruptcy Procedure 4003(a).⁴³ Section 522(1) stipulates that if a debtor files an exemption list, and a party in interest fails to file a timely objection to that list, the listed property is considered exempt from the bankruptcy estate and creditors are not able to subsequently reach that property.⁴⁴ In *Taylor v Freeland & Kronz*,⁴⁵ the Supreme Court interpreted § 522(1) strictly and held that listed property is exempt if the creditor failed to object in time.⁴⁶ However, the Court predicated its strict interpretation of § 522(1) on the fact that the exemptions were claimed in good faith.⁴⁷ The *Taylor* Court then chose not to address whether courts may use their powers under § 105(a), discussed in Part I.C.,⁴⁸ to disallow exemptions not claimed in good faith.⁴⁹ The court did note, though,

³⁸ 11 USC § 522(b)(2).

³⁹ This section of the Code provides, in relevant part, “An individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection.” 11 USC §522(b)(1).

⁴⁰ See Resnick and Sommer, 4 *Collier on Bankruptcy* ¶ 5.22.01 at 522-16–16.1 (cited in note 20) (noting that § 522 allows state legislatures to veto some federal asset exemptions).

⁴¹ See *id.*

⁴² See Richard F. Dole, Jr., *Preserving Rights in a Home through Bankruptcy*, 4 *Bank Dev J* 1 n 15 (1987).

⁴³ Resnick and Sommer, 4 *Collier on Bankruptcy* ¶ 5.22.02[3] at 522-20–21 (cited in note 20).

⁴⁴ The section of the Code governing exemptions provides, in relevant part,

The debtor shall file a list of property that the debtor claims as exempt under subsection (b) of this section. If the debtor does not file such a list, a dependent of the debtor may file such a list, or may claim property as exempt from property of the estate on behalf of the debtor. Unless a party in interest objects, the property claimed as exempt on such list is exempt.

11 USC § 522(1).

⁴⁵ 503 US 638 (1992).

⁴⁶ *Id.* at 643–44 (“Deadlines may lead to unwelcome results, but they prompt parties to act and they produce finality.”).

⁴⁷ See *id.* at 645.

⁴⁸ See Part I.C.

⁴⁹ See 503 US at 645.

that the Code “may limit bad-faith exemptions claimed by debtors,” and it cited several courts that have held accordingly.⁵⁰

C. A Court’s Equitable Powers under § 105(a)

Section 105(a) of the Bankruptcy Code is a statutory grant of equitable powers to bankruptcy courts. The provision states:

*The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.*⁵¹

The purpose of § 105(a) is to enable bankruptcy courts to use equitable powers to carry out other provisions of the Bankruptcy Code.⁵² As § 105(a) jurisprudence indicates, courts are limited in their use of these powers because the courts must derive their power to use § 105(a) from another provision in the Code.⁵³

The history of § 105(a) illustrates why courts may only use this equitable grant of powers to further specific provisions in the Code. The predecessor statute to § 105(a) was § 2a(15) of the Bankruptcy Act.⁵⁴ Section 2a(15) provided bankruptcy courts with the authority to “make such orders, issue such process, and enter such judgments in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this Act.”⁵⁵ The language of § 105(a) provides courts with more power than the predecessor § 2a(15), as it authorizes courts not only to issue orders that are “necessary” for the

⁵⁰ Id at 644–45, citing for example, *Ragsdale v Genesco, Inc.*, 674 F2d 277, 278 (4th Cir 1982) (allowing the bankruptcy judge to determine whether the trustee may object to the debtor’s filed exemption list in an untimely fashion); *In re Staniforth*, 116 BR 127, 131 (Bankr WD Wis 1990) (“[F]or the Debtor to receive an exemption for property which may not be exempt under Wisconsin law simply because the trustee failed to timely object to the Debtor’s exemption would be a manifest miscarriage of justice.”).

⁵¹ 11 USC § 105(a) (emphasis added).

⁵² See *Scrivner*, 535 F3d at 1263.

⁵³ See, for example, id at 1265; *United States v Sutton*, 786 F2d 1305, 1308 (5th Cir 1986) (noting that § 105(a) “does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity”).

⁵⁴ See Resnick and Sommer, 2 *Collier on Bankruptcy* ¶ 105.LH[1] at 105-106 (cited in note 20) (“Section 2a(15) was viewed by most courts as an express sanction of the mandate of the bankruptcy court’s power to enjoin actions of parties.”).

⁵⁵ Id.

provisions of the title, but also to issue orders “appropriate” to carry out the provisions.⁵⁶ However, this power is not unlimited.

Judges and academics have compared a bankruptcy court’s equitable powers under § 105(a) to the All Writs Statute, 28 USC § 1651, which authorized courts to “issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law.”⁵⁷ Unlike § 105(a), the All Writs Statute did not require courts to derive their power from another statutory provision.⁵⁸ In 1978, Congress enacted a new Bankruptcy Reform Act, and it included bankruptcy courts within the scope of the All Writs Statute pursuant to § 213.⁵⁹ Congress additionally created § 105(a) with this Act—which did limit the court’s powers to those that further the provisions of the Code—as a continuation of the All Writs Statute.⁶⁰ By enacting § 105(a), Congress intended to expand a bankruptcy court’s powers by stipulating that § 105(a) was also meant “to cover any powers traditionally exercised by the bankruptcy courts that are not encompassed by the All Writs Statute.”⁶¹ In 1984, however, Congress repealed § 213 of the Bankruptcy Code; bankruptcy courts were thus left with only § 105(a) and its requirement that courts only use the powers in relation to the Code.⁶² Therefore, courts are now required to use their equitable powers only to further a specific provision of the Bankruptcy Code.⁶³

There are two main schools of thought regarding a bankruptcy court’s equitable powers under § 105(a).⁶⁴ The prevailing view is that § 105(a) is a very broad grant of power to bankruptcy courts, and it grants the courts the authority to fill in gaps that the statutory language does not address.⁶⁵ For example, in 2001 the court in *Sears, Roebuck &*

⁵⁶ See Resnick and Sommer, 2 *Collier on Bankruptcy* ¶ 105.LH[2] at 105-106-107 (cited in note 20).

⁵⁷ *Id.* See, for example, *In re NWFEX, Inc.*, 864 F.2d 593, 595 (8th Cir. 1989) (explaining that § 105(a) is comparable to the All Writs Statute); *In re Spectee Group, Inc.*, 185 BR 146, 155 n.15 (Bankr. SDNY 1995) (noting that § 105(a) is the “bankruptcy analogue” to the All Writs Statute); Frederick Tung, *Confirmation and Claims Trading*, 90 Nw U L Rev 1684, 1741 (stating that the grant of power found in § 105(a) is “similar to that found in the All Writs Statute”).

⁵⁸ Resnick and Sommer, 2 *Collier on Bankruptcy* ¶ 105.LH[2] at 105-106-107 (cited in note 20).

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² See Resnick and Sommer, 2 *Collier on Bankruptcy* ¶ 105.LH[3] at 105-107 (cited in note 20) (explaining that this repeal came as a result of the Supreme Court’s decision in *Northern Pipeline Construction Co v Marathon Pipe Line Construction Co.*, 458 US 50 (1982)).

⁶³ See *id.*

⁶⁴ Resnick and Sommer, 2 *Collier on Bankruptcy* ¶ 105.01[2] at 105-7 (cited in note 20).

⁶⁵ See *id.*

*Co v Spivey*⁶⁶ stated that § 105(a) “bestows on bankruptcy courts a specific equitable power to act in accordance with principles of justice and fairness. Bankruptcy courts have broad latitude in exercising this power.”⁶⁷ However, the second school of thought—that § 105(a) is not a broad grant of power to the courts and that it should be construed narrowly—recently has emerged in both the judicial sector and the academic community.⁶⁸ Three years after *Sears, Roebuck & Co*, the Seventh Circuit in the hallmark case of *In re Kmart*⁶⁹ emphasized that the power of § 105(a) is a power “to implement rather than override” and that “[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.”⁷⁰ Both approaches, however, recognize that courts are limited in their use of equitable powers and may not use § 105(a) to create substantive rights or to override explicit mandates in the Code.⁷¹

D. Remedies for Fraud in the Bankruptcy Process

There are several remedies available to bankruptcy courts if a debtor fails to comply with a court’s order to disclose or turn over property. First, courts may issue an order to turnover property pursuant to 11 USC § 542⁷² or an order to avoid transfer of property under 11 USC § 548.⁷³ Second, pursuant to 11 USC § 522(g), courts may

⁶⁶ 265 BR 357 (EDNY 2001).

⁶⁷ Id at 371.

⁶⁸ See, for example, *Scrivner*, 535 F3d at 1263 (emphasizing that courts may not use their equitable powers to contravene other provisions of the Bankruptcy Code).

⁶⁹ 359 F3d 866 (7th Cir 2004).

⁷⁰ Id at 871, quoting *In re Chicago, Milwaukee, St Paul & Pacific RR*, 791 F2d 524, 528 (7th Cir 1986).

⁷¹ See Resnick and Sommer, 2 *Collier on Bankruptcy* ¶ 105.01[2] at 105-7-8 (cited in note 20).

⁷² The section of the Code governing turnover of property to the estate provides, in relevant part,

An entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell or lease . . . or that the debtor may exempt . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.

11 USC § 542(a).

⁷³ The voidable transfer statute reads, in relevant part,

The trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted.

issue a denial of exemptions in the case of voluntary transfers or concealed assets recovered by the trustee.⁷⁴ Third, courts may also dismiss a case “for cause” or for “substantial abuse” pursuant to 11 USC § 707.⁷⁵ Fourth, bankruptcy courts are authorized under 11 USC § 727(a) to deny a debtor’s discharge.⁷⁶ This is a powerful sword that courts can use to punish debtors who abuse the bankruptcy process and waste the courts’ resources. Courts are in agreement that denying a debtor’s discharge is a punitive sanction against the debtor rather than a remedial measure to compensate the creditor.⁷⁷

Finally, in addition to these other statutory powers, bankruptcy courts may impose civil or criminal contempt on a party for violating a court order.⁷⁸ Civil contempt proceedings differ from criminal contempt proceedings based on the purpose of the sanction. Civil contempt proceedings are a remedial measure for the sake of a harmed

11 USC § 548(a)(1).

⁷⁴ The section of the Code governing exemptions provides, in relevant part,

The debtor may exempt under subsection (b) of this section property that the trustee recovers under section 510(c)(2), 542, 543, 550, 551, or 553 of this title, to the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if (1) (A) such transfer was not a voluntary transfer of such property by the debtor; and (B) the debtor did not conceal such property; or (2) The debtor could have avoided such transfer under subsection (f)(1)(B) of this section.

11 USC § 522(g).

⁷⁵ The section of the Code governing case dismissals provides, in relevant part,

After notice and a hearing, the court, on its own motion or on a motion by the United States trustee, trustee (or bankruptcy administrator, if any), or any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts, or, with the debtor's consent, convert such a case to a case under chapter 11 or 13 of this title if it finds that the granting of relief would be an abuse of the provisions of this chapter.

11 USC § 707(b)(1).

⁷⁶ The section of the Code governing discharge provides, in relevant part,

The court shall grant the debtor a discharge, unless . . . (2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed (A) property of the debtor . . . or (B) property of the estate, after the date of the filing of the petition; (6) the debtor has refused, in the case (A) to obey any lawful order of the court.

11 USC § 727(a).

⁷⁷ See *Latman v Burdette*, 366 F3d 774, 782 (9th Cir 2004) (“The remedy of denial of discharge punishes debtors for misconduct in the bankruptcy process.”); *In re Roosevelt*, 87 F3d 311, 317 n 12 (9th Cir 1996), amended by 98 F3d 1169 (9th Cir 1996).

⁷⁸ See *Jove Engineering, Inc v IRS*, 92 F3d 1539, 1553 (11th Cir 1996) (explaining that all courts (including bankruptcy courts) have inherent powers to punish for contempts).

party.⁷⁹ As the Supreme Court noted, “Sanctions in civil contempt proceedings may . . . be employed for either or both of two purposes: to coerce the defendant into compliance with the court’s order, and to compensate the complainant for losses sustained.”⁸⁰ Alternatively, sanctions in criminal contempt proceedings are punitive in nature and are intended to reprimand a party in violation of an order on behalf of the court.⁸¹ These contempt powers are discussed more fully in Part III.B.

II. ANALYSIS OF THE LAW

There is currently a split between circuit courts regarding whether bankruptcy courts may use their equitable powers, granted by § 105(a), to surcharge a debtor’s exempt assets where that debtor failed to disclose or turn over nonexempt property. While the majority of the district and bankruptcy courts to address this question have held that bankruptcy courts may surcharge a debtor’s exempt assets for equitable purposes, the only two circuit courts to confront the issue reached divergent conclusions. Additionally, the Supreme Court has never ruled on whether bankruptcy courts are authorized to surcharge a debtor’s exempt assets.

A. Courts That Allow Creditors to Surcharge a Debtor’s Exempt Assets

Until recently, the leading decision regarding whether a court may allow a surcharge on a debtor’s exempt assets was set forth by the Ninth Circuit in *Latman v Burdette*.⁸² In *Latman*, the court held that, in exceptional circumstances, a court may use its equitable powers to surcharge a debtor’s exempt assets after that debtor failed to disclose property to his creditors.⁸³ The trustee in the case filed a motion to surcharge the debtors’ exemptions after discovering that the debtors failed to accurately account for \$7,000 in cash that they received for selling their automobile and boat immediately before filing a bankruptcy petition.⁸⁴ On the debtors’ accounting sheet, they listed only

⁷⁹ See *Local 28, Sheet Metal Workers’ International Association v EEOC*, 478 US 421, 443 (1986) (affirming civil contempt sanctions on a fund that violated earlier court orders to increase minority membership).

⁸⁰ *United States v United Mine Workers of America*, 330 US 258, 303–04 (1947).

⁸¹ See *Local 28*, 478 US at 443.

⁸² 366 F3d 774 (9th Cir 2004).

⁸³ *Id* at 780.

⁸⁴ *Id* at 779.

\$1,500 in cash on hand.⁸⁵ As the trustee was not able to obtain the proceeds from these sales (the debtors claimed they no longer had the cash), the motion asserted that the \$7,000 should be surcharged against the debtors' wild card exemption, governed by 11 USC § 522(d)(5).⁸⁶ At the time the debtors filed for bankruptcy, the wild card exemption allowed them to exempt up to \$17,850 in property not covered by other § 522(d) exemptions, so long as they did not claim a homestead exemption.⁸⁷ Surcharging assets from the wild card exemption would have rendered the debtors' minivan and engagement ring nonexempt, rather than exempt—as the debtors claimed—under § 522(d)(5).⁸⁸ Additionally, after filing the motion to surcharge, the trustee discovered another bank account that the debtors failed to disclose.⁸⁹ The trustee then filed a motion to either force the debtors to turn over the cash in the bank account to the trustee, or alternatively to further surcharge the debtors' exempt assets, which were filed under the wild card exemption, for that same amount.⁹⁰

The debtors in *Latman* argued that the court exceeded its equitable powers under § 105(a) by allowing the trustee to surcharge the debtors' exempt assets.⁹¹ They claimed that the Code is silent regarding a surcharge remedy and that allowing a surcharge of exemptions is inconsistent with providing debtors with a fresh start.⁹² However, the Ninth Circuit upheld the bankruptcy court's surcharge because “the bankruptcy judge *prevented what would otherwise have been a fraud on the bankruptcy court and the Latmans' creditors.*”⁹³ The surcharge did not cause the debtors to receive a lower value of assets than was permitted by § 522; the surcharge merely prevented the debtors from retaining more assets than permitted under the exemption statute.⁹⁴ If the court did not allow a surcharge in this case, the debtors would have been able to obtain the full value of the exemption statute *plus* the improperly retained assets, thus exceeding the limit of their statu-

⁸⁵ *Id.*

⁸⁶ *Latman*, 366 F3d at 779. See note 36 and accompanying text.

⁸⁷ *Id.* at 779 n 1.

⁸⁸ *Id.* at 779.

⁸⁹ *Id.*

⁹⁰ *Latman*, 366 F3d at 779.

⁹¹ *Id.* at 784–85.

⁹² *Id.* at 785.

⁹³ *Id.* (emphasis added).

⁹⁴ *Latman*, 366 F3d at 785.

tory exemptions.⁹⁵ Therefore, the surcharge was not inconsistent with the Code's purpose of providing debtors with a fresh start.⁹⁶

The Ninth Circuit, however, did not provide courts within its jurisdiction with a blanket allowance to issue surcharges. It limited the use of the remedy to exceptional circumstances where it would "be the only means fairly to ensure that the debtors retain their statutory 'fresh start,' while also permitting creditors access to property in excess of that which is properly exempted under the Bankruptcy Code."⁹⁷ The court noted that such a situation might arise where other remedies, such as a turnover order, would be futile because assets withheld from the trustee were either lost or converted for personal benefit by the debtor.⁹⁸ In line with *Latman*, numerous bankruptcy courts both within the Ninth Circuit and in other circuits have also allowed creditors to surcharge a debtor's exempt assets.⁹⁹

B. Courts That Do Not Allow Creditors to Surcharge Exempt Assets

Recently, the Tenth Circuit in *Scrivner* created a split in the courts and held that § 105(a) does not authorize courts to use their equitable powers to surcharge a debtor's exempt assets as a remedy for failing to disclose or turn over nonexempt property.¹⁰⁰ In *Scrivner*, the debtors failed to surrender postpetition distributions from their interest in a television show, thus violating a court order to turn over the proceeds.¹⁰¹ However, since the court had already ordered a discharge of their debt, the debtors refused to turn over the proceeds and claimed that the court could not compel them to do so.¹⁰² The trustee then filed a motion asking the court to surcharge the debtors' exempt assets, which the bankruptcy court granted.¹⁰³ On appeal, the Tenth Circuit reversed the bankruptcy court's order.¹⁰⁴

The Tenth Circuit reached its conclusion by performing a statutory analysis of the issue. It noted that bankruptcy courts may not use

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.* at 786.

⁹⁸ See *Latman*, 366 F3d at 785 n 8 (acknowledging that the Code does not explicitly provide for a remedy of surcharge against a debtor's exemptions in the case of an underreporting of assets).

⁹⁹ See generally, for example, *In re Ross-Tucker*, 2005 WL 3263932 (Bankr DDC); *Karl v Karl*, 313 BR 827 (Bankr WD Mo 2004); *In re Ward*, 210 BR 531 (Bankr ED Va 1997).

¹⁰⁰ 535 F3d at 1265.

¹⁰¹ *Id.* at 1262.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ 535 F3d at 1267.

their equitable powers in a way that is inconsistent with the rest of the Bankruptcy Code, and this includes disregarding the plain language of a statute.¹⁰⁵ The general rule from § 522(1) of the Bankruptcy Code is that property is exempt if a debtor claims it as exempt and the creditor fails to object to the claim in a timely manner.¹⁰⁶ The court noted that the Code specifically enumerates exceptions to this general rule, but it never authorizes a court to surcharge a debtor's exempt assets.¹⁰⁷ The court therefore held that "[b]ecause the Code contains explicit exceptions to the general rule placing exempt property beyond the reach of the estate, we may not read additional exceptions into the statute."¹⁰⁸

Additionally, the court identified specific remedies stipulated in the Code for a creditor when a debtor fails to turn over estate property to the trustee, and it emphasized the fact that surcharging a debtor's exempted assets is not a named remedy.¹⁰⁹ The court explained that "we are not at liberty 'to grant any more or less than what the clear language of [the Bankruptcy Code] mandates.'"¹¹⁰ For instance, the court pointed to revoking the debtor's discharge, authorized by § 727(d)(3), and imposing sanctions for civil contempt as possible remedies within the Code.¹¹¹ It recognized that the Bankruptcy Code's equitable powers provision "does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law."¹¹²

Although the Tenth Circuit split from other courts in *Scrivner*, it is important to note that the court did not do so enthusiastically. Rather, the court recognized that

the arguments supporting a surcharge of exempt assets are compelling. . . . Allowing the debtors to keep the full value of their exempt assets, when they have kept or converted assets belonging to the estate, arguably gives the debtors an undeserved benefit at the expense of the estate and the creditors.¹¹³

¹⁰⁵ Id at 1263.

¹⁰⁶ Id at 1264.

¹⁰⁷ Id (referring to §§ 522 (c), (k)).

¹⁰⁸ *Scrivner*, 535 F3d at 1264.

¹⁰⁹ Id.

¹¹⁰ Id, quoting *In re Alderete*, 412 F3d 1200, 1206 (10th Cir 2005).

¹¹¹ *Scrivner*, 535 F3d at 1265 (suggesting that denial of discharge of debt, rather than surcharge through § 105(a), is the appropriate way for courts to incentivize correct debtor behavior and protect creditors).

¹¹² Id, quoting *United States v Sutton*, 786 F2d 1305, 1308 (5th Cir 1986).

¹¹³ *Scrivner*, 535 F3d at 1264.

However, the court noted that it was the legislature's responsibility to modify the law, not the judiciary's.¹¹⁴ Thus, the Tenth Circuit held that § 105(a) does not empower courts to create rights and remedies in derogation of the Code, and since the Code does not provide creditors with a right to surcharge exempt assets, § 105(a) does not provide the courts with this right.¹¹⁵

Recently, in *In re Mazon*¹¹⁶ a district court in the Eleventh Circuit also confronted the issue of whether a bankruptcy court may use its equitable powers to surcharge a debtor's exempt assets, reaching the same conclusion as the *Scrivner* court.¹¹⁷ In *Mazon*, the debtors failed to account for their interest in two companies, which, once discovered, the court found to be estate property.¹¹⁸ However, while the companies were extremely valuable to the estate at the time the debtors filed for bankruptcy, the debtors subsequently used and dissipated nearly all of the companies' assets to furnish their lifestyle in lieu of using their exempt assets.¹¹⁹ The trustee asked the court to surcharge the debtors' exempt assets in order to acquire the value of the estate property that he would have received had the debtors not concealed and used up the companies' assets.¹²⁰ The bankruptcy court granted the motion but the district court reversed the ruling; like the *Scrivner* court, it based its reasoning on a statutory analysis of the Bankruptcy Code.¹²¹

In short, there is a fundamental disagreement about whether the equitable power enshrined by § 105(a) allows a court to surcharge a debtor's exempt assets where the debtor has committed fraud on the bankruptcy court. The next Part discusses the relative merits of these arguments and contends that § 105(a) should not be interpreted to allow courts to surcharge exempt assets. However, it also proposes an alternative method of accomplishing the same result: through the courts' contempt powers.

¹¹⁴ *Id.* at 1263.

¹¹⁵ *Id.* at 1265.

¹¹⁶ 395 BR 742 (MD Fla 2008).

¹¹⁷ *Id.* at 744.

¹¹⁸ *Id.* at 745.

¹¹⁹ *Id.* at 746.

¹²⁰ *Mazon*, 395 BR at 746.

¹²¹ *Id.* at 750.

III. SOLUTION: RECOGNIZING THE LIMITS OF § 105(A) AND THE POWER OF CONTEMPT

This Part analyzes the current split in the courts and puts forth a novel solution. Part III.A first argues that *Scrivner* is correct and that courts do in fact exceed their equitable powers by creating a substantive right to surcharge a debtor's exempt assets. Part III.B then discusses the broad grant of powers available to courts when sanctioning a party in contempt. Finally, Part III.C applies the court's contempt powers to cases where a debtor fraudulently retains estate property. It argues that courts should be able to use their contempt powers to sanction a debtor by reaching his exempt assets, provided it is appropriate under the circumstances. This equitable approach allows courts to compensate the harmed creditors without exceeding their authority.

A. It Is Beyond a Court's Equitable Power to Create a Substantive Right to Surcharge a Debtor's Exempt Assets

1. It is beyond the bankruptcy court's inherent powers as a court in equity to create a substantive right or remedy to surcharge.

Bankruptcy courts historically have been granted the same powers as courts in equity.¹²² The Judiciary Act of 1789 granted jurisdiction to all federal courts for "all suits . . . in equity," and the Supreme Court held that "the 'jurisdiction' thus conferred . . . is an authority to administer in equity suits the principles of the system of judicial remedies which has been devised and was being administered by the English Court of Chancery at the time of the separation of the two countries."¹²³ However, this power does not equate with the ability to create new rights for creditors or powers for the court.

This theory of the limited powers of the bankruptcy court was recently upheld by the Supreme Court in *Grupo Mexicano De Desarrollo v Alliance Bond Fund, Inc.*,¹²⁴ where the Court performed an in-depth analysis of a court's power in equity and held that a court may not use its equitable powers to invoke a new form of relief.¹²⁵ Specifically, the Court held that the bankruptcy court lacked the authority to issue a preliminary injunction that would prevent a note issuer from

¹²² See *Pepper v Litton*, 308 US 295, 303 (1939); Part I.A.

¹²³ *Atlas Life Insurance Co v W. I. Southern Inc.*, 306 US 563, 568 (1939).

¹²⁴ 527 US 308 (1999).

¹²⁵ See *id.* at 319–23.

disposing of the note holder's assets.¹²⁶ It reasoned that because courts of equity traditionally did not accord this type of relief, the bankruptcy court lacked the inherent equitable power to create the remedy.¹²⁷ The Court cited William Blackstone to support its contention that courts lack the power to use equity to create a remedy whenever a remedy at law is inadequate.¹²⁸ While the Court recognized that "equity is flexible," it also noted that the "flexibility is confined within the broad boundaries of traditional equitable relief. To accord a type of relief that has never been available before . . . is to invoke a 'default rule' . . . not of flexibility but of omnipotence."¹²⁹ Instead, as the Court recognized, it is the legislature's duty, rather than the judiciary's, to design an alternative remedy.¹³⁰

Therefore, based on this recent Supreme Court case, in order to determine whether a bankruptcy court may use its inherent powers as a court in equity to issue a surcharge remedy, the court must determine whether courts of equity traditionally permitted the requested relief.¹³¹ In addition, as the court in *Mazon* noted, courts in equity were not permitted to surcharge a debtor's exempt assets to compensate creditors who were unable to obtain the debtor's nonexempt assets.¹³² Accordingly, bankruptcy courts may not base their right to surcharge on their inherent equitable powers.

2. It is beyond a court's statutory equitable powers under § 105(a) to create a substantive right to surcharge.

It is widely recognized that it is beyond a court's power to use § 105(a) to create a new substantive right or remedy.¹³³ In particular,

¹²⁶ Id at 333.

¹²⁷ Id (basing its reasoning on limitations in equity against injunctions that would interfere with property use).

¹²⁸ See 527 US at 321, quoting Joseph Story, 1 *Commentaries on Equity Jurisprudence* § 12 at 14–15 (Hilliard, Gray 1836) (noting that Blackstone once remarked "that it is the business of a Court of Equity, in England, to abate the rigor of the common law. But no such power is contended for. Hard was the case of bond creditors But a Court of Equity can give no relief.").

¹²⁹ *Grupo Mexicano*, 527 US at 322.

¹³⁰ Id (explaining that Congress is better suited to analyze "new conditions that might call for a wrenching departure from past practice").

¹³¹ See id at 339–40 (noting that the judicial creation of remedies could disrupt the balance between debtors' and creditors' rights that had developed over centuries).

¹³² See 395 BR at 750 ("[T]hat the inherent powers of a bankruptcy court provide no greater authority in the context of this case than does § 105(a) and do not allow the imposition of a surcharge on exempt assets."). The court based its conclusion on the fact that there is no appellate decision that provides precedent suggesting that it is within a court's inherent powers to surcharge a debtor's exempt assets. Id.

¹³³ See Part I.C.

courts may only issue orders that are “necessary or appropriate to carry out the provisions” of the Code.¹³⁴ The *Scrivner* and *Mazon* courts were therefore correct in holding that it is beyond a bankruptcy court’s equitable powers to create a discretionary right to surcharge a debtor’s exempt assets.¹³⁵ Allowing courts to use § 105(a) to surcharge a debtor’s exempt assets expands the Code’s equitable powers too far, and this is evidenced by the fact that the courts that have used § 105(a) to surcharge a debtor’s exempt assets have based their entire power on the *purpose* of doing so, rather than asserting that it fulfills a substantive provision of the Code.¹³⁶ For example, the *Latman* court based its holding on the fact that authorizing a surcharge prevented a fraud on the court.¹³⁷ However, while debtors’ fraudulent behavior is a compelling reason to allow courts to issue a surcharge, which the *Scrivner* court noted,¹³⁸ § 105(a) still requires the court to further a substantive provision in the Code in order to use its equitable powers.

The principle that courts may not use § 105(a) to fashion new rights or remedies is demonstrated by the laws regarding setoffs in bankruptcy proceedings. A setoff is a nonbankruptcy right that allows parties to exchange one debt for another.¹³⁹ Setoffs are permitted in bankruptcy proceedings pursuant to § 553(a) of the Code, which stipulates that creditors and debtors are not prevented from setting off mutual debts owed to each other provided the debts arose before the commencement of the case.¹⁴⁰ However, courts are not able to use their equitable powers to create a right to setoff a debt.

¹³⁴ 11 USC § 105(a) (emphasis added). See Part I.C.

¹³⁵ See Part II.B.

¹³⁶ See Part II.A. See also *In re Ward*, 210 BR 531, 538 (Bankr ED Va 1997) (“To allow a debtor who has converted property of the estate to be paid his or her exemption without having to account to the trustee by way of setoff for the value of the converted property strikes at the very integrity of the bankruptcy process.”).

¹³⁷ *Latman*, 366 F3d at 785.

¹³⁸ See Part II.B.

¹³⁹ As Justice Antonin Scalia explained, “The right of setoff [] allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A.” *Citizens Bank of Maryland v Strumpf*, 516 US 16, 18 (1995).

¹⁴⁰ The section of the Code governing setoff provides, in relevant part,

[T]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case.

11 USC § 553(a). In order to set off debts under § 553, courts require three elements: (1) a prepetition debt owed by the creditor to the debtor; (2) a prepetition debt owed by the debtor to the creditor; and (3) the debt and claim are mutual obligations. See *In re Gould*, 389 BR 105, 112 (Bankr ND Cal 2008).

For example, in *In Re NWF*,¹⁴¹ the Eighth Circuit held that § 105(a) does not provide courts with the right to issue an equitable setoff.¹⁴² In *NWF*, the debtor asked the bankruptcy court to issue a setoff under § 553 of the Code, but the court refused because the parties lacked the required mutuality of debt.¹⁴³ However, the bankruptcy court granted an “equitable setoff” by invoking its equitable powers under § 105(a).¹⁴⁴ The Eighth Circuit reversed the bankruptcy court’s ruling because the bankruptcy court had expanded its equitable powers beyond what the Code permits.¹⁴⁵ The Eighth Circuit held that § 105(a) is a procedural instrument which does not delineate substantive rights upon the courts.¹⁴⁶ Creating a right to issue an “equitable setoff” is fashioning a substantive right, and it is therefore beyond the powers set forth in the Code.¹⁴⁷

The concept of creating a right to setoff debts by using equitable powers is similar to creating a right to surcharge assets by using equitable powers.¹⁴⁸ Both would allow the creditor to exchange one debt for another by relying solely on § 105(a).¹⁴⁹ However, like an equitable setoff, an equitable surcharge acts as a substantive right rather than a procedural right.¹⁵⁰ Since courts that authorize a surcharge use only § 105(a) and are not able to rely on a substantive bankruptcy provision that permits or requires the court to issue a surcharge, § 105(a) functions substantively, as opposed to procedurally. Therefore, as the *Scrivner* court’s statutory interpretation and the setoff case law demonstrate,¹⁵¹ a court exceeds its power when it uses its equitable powers—either inherently as a court in equity or pursuant to § 105(a)—to create a substantive right to surcharge a debtor’s exempt assets.

To sum up, courts should not be able to use their § 105(a) powers to surcharge a debtor’s exempt assets to prevent the “fraud on the

¹⁴¹ 864 F2d 593 (8th Cir 1989).

¹⁴² *Id.* at 596.

¹⁴³ *Id.* at 595.

¹⁴⁴ *Id.* Note the distinction between setoffs pursuant to § 553 (setoffs that satisfy the requirements of the statute) and setoffs pursuant to § 105(a) (setoffs that do not satisfy those requirements, and thus solely rely on § 105(a)).

¹⁴⁵ *NWF*, 864 F2d at 596.

¹⁴⁶ *Id.* at 595.

¹⁴⁷ *Id.* at 596.

¹⁴⁸ In fact, courts have even analyzed setoffs and surcharges in a similar fashion. For example, the court in *In re Price*, 384 BR 407 (Bankr ED Va 2008), held that the trustee may setoff the debtor’s exempt assets, or in the alternative, surcharge the exempt assets. *Id.* at 410–12.

¹⁴⁹ In the case of a surcharge, the creditor would be able to reach the debtor’s exempt assets to offset the value of nonexempt assets that the debtor failed to disclose or turnover.

¹⁵⁰ See Part II.B.

¹⁵¹ See Part II.A.2.

bankruptcy court”¹⁵² that *Latman* wanted to avoid. As the Tenth Circuit in *Scrivner* dictated, this practice of creating new rights or remedies expands a court’s equitable powers beyond its limits. However, there may be a way of remedying this type of injustice and deterring its future use through a power already within the hands of bankruptcy courts: the power of contempt.

B. Courts Have Broad Rights through Their Powers of Contempt to Sanction Parties Who Violate a Court Order

1. A court’s civil contempt power.

Courts are entitled to hold a party in contempt of court where that party acted in bad faith or violated a court order.¹⁵³ All courts have contempt powers, including bankruptcy courts, and the courts may use these powers to sanction violators with either civil or criminal contempt of court.¹⁵⁴ The courts’ inherent contempt powers arise independent of statutory authority and are available for courts to use in order to “achieve the orderly and expeditious disposition of cases.”¹⁵⁵ Courts may impose contempt sanctions for several reasons: to coerce a party to obey a court order, to compensate a complainant who was harmed by a party’s failure to obey a court order, or to deter parties from violating court orders in the future.¹⁵⁶

Bankruptcy courts therefore may sanction a party in violation of a court order to further the proceeding as a whole and to enforce the provisions of the Code. However, while the courts are granted broad discretionary power to determine the proper contempt sanctions, they are not without their limits. For civil contempt, the sanction should be remedial and compensatory, as opposed to criminal contempt, where the sanction is meant to punish the violator.¹⁵⁷ The Fifth Circuit has

¹⁵² *Latman*, 366 F3d at 785.

¹⁵³ See *In re Dyer*, 322 F3d 1178, 1196 (9th Cir 2003).

¹⁵⁴ See *Jove Engineering, Inc v IRS*, 92 F3d 1539, 1553 (11th Cir 1996). Courts have additionally held that bankruptcy courts are granted statutory contempt powers pursuant to § 105(a) of the Bankruptcy Code. See *id.* at 1554. These powers further enhance the bankruptcy court’s ability to hold a debtor in contempt in order to further the administration of the bankruptcy case. See *id.* at 1554.

¹⁵⁵ See *Chambers v NASCO, Inc*, 501 US 32, 43 (1991) (discussing a federal court’s contempt powers). See also *Jove Engineering*, 92 F3d at 1553 (discussing a bankruptcy court’s contempt powers).

¹⁵⁶ See *Local 28, Sheet Metal Workers’ International Association v EEOC*, 478 US 421, 443 (1986). See also *In re General Motors Corporation*, 61 F3d 256, 258 (4th Cir 1995) (discussing the purposes of a court’s contempt powers).

¹⁵⁷ See *General Motors*, 61 F3d at 259 (using civil contempt power to compensate defendant after misconduct of plaintiff’s counsel caused defendant to face lawsuits in other jurisdictions).

stated that compensatory sanctions “may not exceed the actual loss to the complainant caused by the actions of respondent, lest the contempt fine become punitive in nature, which is not appropriate in a civil contempt proceeding.”¹⁵⁸

Where one party is harmed by another party’s conduct in a court proceeding, that party may motion the court to find the other in contempt of a court order.¹⁵⁹ A party seeking to hold another in civil contempt of court typically must demonstrate by clear and convincing evidence that a violation occurred.¹⁶⁰ There are numerous tests used by courts to determine whether a party in fact violated a court order, and most courts only require a violation, without intent, in order to hold a party in contempt.¹⁶¹ However, some courts do require willful intent to violate a court order in order to hold the violating party in contempt.¹⁶²

2. Distinguishing contempt powers from equitable powers.

A bankruptcy court’s contempt powers are distinct from its equitable powers under § 105(a). First, a court can only exercise its contempt powers if a party violates an identifiable court order. However, it can use its equitable powers throughout the entire bankruptcy proceeding, regardless of the debtor’s conduct.¹⁶³

Second, when a court uses its contempt powers, it is irrelevant whether the order that was violated stems from the Bankruptcy Code or nonbankruptcy law. Punishing for contempt is thus a nonbankruptcy right that is granted to judges whether they are bankruptcy judges or nonbankruptcy judges. A court’s equitable powers, on the other hand, are exclusively a bankruptcy tool and only may be used to help the court advance a specific provision of the Bankruptcy Code.

Third, a court’s equitable powers and its contempt powers perform different functions, though they may at times overlap. A court only employs its equitable powers to advance the provisions of the

¹⁵⁸ *NLRB v Laborers’ International Union*, 882 F2d 949, 955 (5th Cir 1980).

¹⁵⁹ See FRBP 9020 (stating that the rule governing contested matters governs motions for contempt made by the trustee or a party in interest).

¹⁶⁰ See *King v Allied Vision*, 65 F3d 1051, 1058 (2d Cir 1995).

¹⁶¹ See *McComb v Jacksonville Paper Co*, 336 US 187, 191 (1949). See also *General Motors*, 61 F3d at 258 (“Willfulness is not an element of civil contempt.”).

¹⁶² See, for example, *Jove Engineering*, 92 F3d at 1555. Although the definition of willfulness varies, “willfulness generally connotes intentional action taken with at least callous indifference for the consequences.” *Sizzler Family Steak Houses v Western Sizzlin Steak House, Inc.*, 793 F2d 1529, 1535 (11th Cir 1986). These courts often use a general “willful violation” test to hold a party in contempt. See *Jove Engineering*, 92 F3d at 1555. This test requires that the offending party (1) knew the order was issued and (2) intended the actions which violated the order. See *id* at 1555.

¹⁶³ See *Bessette v Avco Financial Services, Inc.*, 230 F3d 439, 444–45 (1st Cir 2000).

Bankruptcy Code.¹⁶⁴ A court's civil contempt powers, however, exist to both further the bankruptcy proceeding as a whole and to compensate a party who was harmed by virtue of another party's contemptuous conduct.¹⁶⁵ Therefore, while a court's contempt powers only may be used to sanction a party who violates a court order, they are far broader in scope than the equitable powers; they are rights that courts may use to enforce provisions of the Code, further the purposes of the Code, enforce other state and federal laws, coerce a party to comply with a court order, compensate a harmed party, or, in the case of criminal contempt, punish a party who violates a court order.¹⁶⁶

In *Walls v Wells Fargo Bank*,¹⁶⁷ the Ninth Circuit recognized this distinction.¹⁶⁸ In *Walls*, the debtor argued that § 524 of the Bankruptcy Code created a substantive right to a discharge injunction (meaning the creditor could no longer pursue the debtor's debt), and that § 105(a) should be available to enforce the right where the creditor violated the injunction.¹⁶⁹ The court, however, disagreed.¹⁷⁰ It held that § 105(a) cannot be used to create substantive rights or remedies that are not stipulated in the Code and that creating a private right of action to enforce § 524 would be expanding the court's powers too far.¹⁷¹ However, the court held that it could use its civil contempt powers to remedy the situation.¹⁷² It explained that civil contempt is the typical sanction for violations of § 524 and was a sufficient remedy in this case because it is both compensatory and forces the creditor to abide by the injunction.¹⁷³ Therefore, the court held that while a court's equitable powers under § 105(a) do not provide the debtor with the substantive right to remedy a discharge injunction, its civil contempt powers could be used to provide a remedy.¹⁷⁴

¹⁶⁴ See Part I.C.

¹⁶⁵ See Part III.B.1.

¹⁶⁶ See *id.*

¹⁶⁷ 276 F3d 502 (9th Cir 2001).

¹⁶⁸ *Id.* at 505 (examining a case where the debtor alleged that the creditor solicited and collected monthly payments from the debtor after discharge).

¹⁶⁹ *Id.* at 506.

¹⁷⁰ *Id.* at 507.

¹⁷¹ *Walls*, 276 F3d at 507.

¹⁷² *Id.* (“[C]ivil contempt is the normal sanction for violation of the discharge injunction . . . civil contempt allows an aggrieved debtor to obtain compensatory damages . . . [it] is the appropriate remedy and no further remedy is necessary.”) (quotation marks omitted).

¹⁷³ *Id.*

¹⁷⁴ *Id.*

3. Courts frequently use their contempt powers to issue sanctions for numerous types of violations.

Courts have used their contempt powers to fashion numerous remedies where parties violate court mandates. As long as the sanction is remedial and compensatory, it is “within the court’s broad discretion.”¹⁷⁵ Several courts have used their contempt powers, as opposed to their equitable powers, to create a private right of action because it compensates the harmed party. For example, in *Rodriguez v Countrywide Home Loans*,¹⁷⁶ the court held that courts may use their contempt powers to allow debtors to recover for the creditor’s violation of bankruptcy provisions that do not separately provide the debtors with a private right of action.¹⁷⁷ In *Rodriguez*, the creditor alleged that the debtors’ complaint, which sought relief for violations of the orders for an automatic stay and a discharge injunction, should be dismissed for failure to state a claim because these provisions do not create a private right of action.¹⁷⁸ However, the court differentiated the plaintiffs’ request that the court imply a private right of action for relief from violations of orders.¹⁷⁹ While the court recognized that it could not use its equitable powers under § 105(a) to create a substantive right, it asserted that it could use its statutory contempt powers to enforce a provision of the Code.¹⁸⁰ In reaching its conclusion, the *Rodriguez* court interpreted a court’s contempt powers broadly. It held that while bankruptcy courts are not permitted to create new substantive rights, they may use their contempt powers, when a party violates a court order, to enforce substantive rights.¹⁸¹ Therefore, the court used its contempt powers to allow the debtors to obtain damages for violations of court orders, as doing so enforced rights provided in the Bankruptcy Code.¹⁸²

A bankruptcy court has in fact used its contempt powers to sanction a debtor by surcharging his exempt assets for actions other than fraudulent concealment of assets. In *In re Swanson*,¹⁸³ the debtor claimed \$15,800 as exempt under § 522(d).¹⁸⁴ The trustee sold the debtor’s residence at an auction, and the court ordered the debtor to re-

¹⁷⁵ *General Motors*, 61 F3d at 259.

¹⁷⁶ 396 BR 436 (Bankr SD Tex 2008).

¹⁷⁷ *Id.* at 460.

¹⁷⁸ *Id.* at 455.

¹⁷⁹ *Id.* at 460.

¹⁸⁰ *Rodriguez*, 396 BR at 460.

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ 207 BR 76 (Bankr D NJ 1997).

¹⁸⁴ *Id.* at 77.

move his personal items and vacate the property.¹⁸⁵ The debtor, however, continued to remain in his house.¹⁸⁶ A US Marshal eventually removed the debtor and his personal property, causing the trustee to incur a \$10,000 administrative expense.¹⁸⁷ The court found the debtor in contempt of court and sanctioned him by permitting the trustee to surcharge the debtor's exempt assets to pay for the additional administrative costs.¹⁸⁸ While, as the court recognized, § 522(k) prevents a trustee from surcharging a debtor's exempt assets for administrative expenses, the court held that it could use its contempt power to surcharge the exempt assets as a sanction for violating the court order.¹⁸⁹

Additionally, courts have held that judges may take the value of exempt assets into consideration when determining an appropriate sanction for contempt.¹⁹⁰ For example, in *BKS Properties, Inc v Shumate*,¹⁹¹ a bankruptcy court held the debtor in contempt for violating a court order and sanctioned the debtor with a monetary judgment.¹⁹² The debtor failed to pay the judgment and appealed the sanction, claiming he was unable to satisfy the monetary judgment.¹⁹³ In assessing whether the debtor was capable of paying the issued sanction, the court took into account the value of the debtor's house, even though it was exempt property.¹⁹⁴ The court recognized that “[w]hile his house may be exempt from collection actions taken by his creditors, [the debtor] has the right, and the ability, to use the equity in his house to purge his contempt.”¹⁹⁵ These cases therefore demonstrate the broad discretion that bankruptcy judges have in how and when they may exercise their contempt powers.

¹⁸⁵ Id.

¹⁸⁶ Id.

¹⁸⁷ 207 BR at 77.

¹⁸⁸ Id at 80–81 (analogizing the situation to one where the principle of setoff provides an appropriate remedy, and thereby finding that the debtor was obligated to the trustee in the amount of damages incurred due to its contempt).

¹⁸⁹ Id at 81.

¹⁹⁰ See *SEC v AMX, International, Inc*, 7 F3d 71, 76 (5th Cir 1993) (allowing defendant's home to be considered by the court in determining whether he is financially able to pay the disgorgement order); *BKS Properties, Inc v Shumate*, 271 BR 794, 803 (ND Tex 2002) (holding that the exempted value of a debtor's home could not be considered in bankruptcy, but could be considered in the context of a contempt order).

¹⁹¹ 271 BR 794, 803 (ND Tex 2002).

¹⁹² Id at 798.

¹⁹³ Id at 803.

¹⁹⁴ Id (noting that it was accepted in the Fifth Circuit for a court to consider a contemnor's exempt assets in assessing contempt sanctions).

¹⁹⁵ Id.

C. Surcharging a Debtor's Exempt Assets Should Therefore Be within the Court's Contempt Powers

In a bankruptcy proceeding, if a debtor fails to comply with a rule or a court order, there are several avenues that the court may pursue. Depending on the debtor's violation, the court may be entitled to deny that debtor a discharge under § 727, issue a turnover order under § 542, dismiss the case pursuant to § 707, or fashion another remedy by using its equitable powers to further another provision of the Code.¹⁹⁶ Additionally, the court may be able to hold that debtor in contempt for disobeying a court order and consequently use its broad discretionary contempt powers to sanction the debtor.

The courts that have used their equitable powers under § 105(a) to create a right to surcharge a debtor's exempt assets, where that debtor failed to disclose or turnover nonexempt property, have overstepped their boundaries. This was recognized by the two most recent courts to confront the situation.¹⁹⁷ However, while the *Scrivner* court asserted that only the legislature could rectify this loophole in the bankruptcy code, the courts have another option in these situations. If the debtor in fact violated a court order by unlawfully concealing property that it was supposed to disclose or by failing to turn over property or assets as required, courts may hold the debtor in civil contempt. Bankruptcy courts may thereafter fashion a remedy that is appropriate to compensate the creditor who is harmed by the debtor's actions and additionally to coerce the debtor to obey the order. In a case where a debtor fails to turn over or disclose nonexempt property, but simultaneously maintains the entire value of his permitted exemptions, and where the creditors are no longer able to reach the non-exempt assets, a court should be permitted to enter an order of contempt against that debtor and issue a surcharge of his exempt property.

1. Justifications for allowing courts to issue a surcharge of exempt property as a sanction for civil contempt.

There are several rationales for allowing a court to reach a debtor's exempt assets where that debtor willfully violated a court order to disclose or turn over estate property. First, it will compensate the aggrieved creditor who was harmed by the debtor's failure to properly comply with the bankruptcy process. Case law indicates that one of the main purposes of civil contempt is to provide compensation to a

¹⁹⁶ See Part I.D.

¹⁹⁷ See Part II.B.

complainant for the violator's harmful conduct.¹⁹⁸ In these cases, if the debtor is permitted to keep the full value of his exemptions as well as the value of the improperly retained assets, the debtor benefits from property that is rightfully the creditor's. The Tenth Circuit in fact recognized this in *Scrivner* and claimed that "[a]llowing the debtors to keep the full value of their exempt assets, when they have kept or converted assets belonging to the estate, arguably gives the debtors an undeserved benefit at the expense of the estate and the creditors."¹⁹⁹

While denying a discharge of debt or dismissing the bankruptcy suit may punish the debtor, doing so will not compensate a creditor if the debtor is otherwise insolvent or refuses to pay his debts.²⁰⁰ The creditor's claim will survive the bankruptcy proceeding in these situations, but the creditor will likely still have difficulty collecting the debt. For example, if the debtor acted fraudulently during the course of the bankruptcy proceeding, such as concealing estate property or refusing to turn over assets, the debtor may act fraudulently in a suit outside of bankruptcy as well. Additionally, initiating another suit that is outside of bankruptcy will impose increased costs on creditors. The creditors will no longer have a trustee responsible for collecting debt from the debtor; they will be forced to spend time initiating and pursuing a new suit in court, and they will have to pay the additional costs associated with a new lawsuit. Also, if the case goes to trial, a jury may be required to determine the proper damages, which is even more time-consuming and expensive.²⁰¹ Bankruptcy proceedings, however, are courts in equity, and judges are able to execute the case without a jury.

Second, if a creditor's claim against the debtor survives bankruptcy, it may be very difficult, expensive, and time-consuming to collect, and this particularly affects small and less established creditors. Considering that the proceedings in these cases apply to individuals, rather than corporations, their creditors may frequently be smaller creditors rather than large, institutional creditors with the resources to easily pursue a debt outside of bankruptcy. In practice, many of these creditors will probably not be able to recover their debts.²⁰² Therefore, while

¹⁹⁸ See Part III.B.1.

¹⁹⁹ 535 F3d at 1263.

²⁰⁰ See *Latman*, 366 F3d at 782 (noting that a denial of discharge is a punitive sanction meant to punish debtors for misconduct in the process).

²⁰¹ See, for example, *In re We Care Products, Inc.*, 1996 WL 762326, *9 (Bankr DDC).

²⁰² For example, the trustee in *Latman* motioned the court for a surcharge in order to recover \$7,000. 366 F3d at 779. In order to recover this without a surcharge, the creditors would have to bring suit outside of bankruptcy without the help of a trustee. This is a relatively small

denying a discharge or dismissing a case are powerful punitive sanctions that courts may use against debtors, they do little to compensate the creditors harmed by the situation. Alternatively, allowing creditors to recover the value of the hidden property by reaching the debtor's exempt assets provides compensation to the wronged creditor where other remedies provided in the Code do not.

Third, sanctioning debtors by allowing creditors to reach their exempt assets coerces the debtor to surrender the value of the concealed assets. As the Supreme Court recognized in *Local 28, Sheet Metal Workers' International Association v EEOC*,²⁰³ one of the courts' main goals in issuing a contempt sanction is to coerce a party to obey a court order.²⁰⁴ By surcharging the debtor's exempt assets for the value of the undisclosed nonexempt assets, the courts would be in effect forcing the debtor to obey the original order that either required the debtor to disclose all of his assets or to turn over all of his nonexempt assets.

Fourth, permitting creditors to surcharge a debtor's exempt assets further deters debtors from attempting to conceal, keep, or furtively transfer assets. If debtors are aware *ex ante* that the court can sanction the debtor by deducting the value of undisclosed assets from their permitted exemptions, then debtors may be less likely to attempt to improperly conceal or keep their nonexempt assets. However, if, as the *Scrivner* court mentioned, courts may not reach these nonexempt assets or surcharge the debtor's exempt assets, debtors may be incentivized to attempt to conceal and dissipate nonexempt assets in the future.

While denying a discharge may also deter debtors from fraudulently concealing assets in most cases, there might be situations where surcharging the debtor's exempt assets would act as a greater deterrent than denying discharge. For example, if a debtor knows that his creditor would be unable to collect his debt, might soon go out of business, or would not discover undisclosed assets in time to stop the debtor from exhausting valuable estate property, then a denial of discharge might not concern the debtor. However, if the debtor is aware that the court would allow the creditor to reach his exempt assets as a consequence for hiding or refusing to turn over assets, then that creditor would have a greater incentive to comply with the court orders. Therefore, allowing courts to sanction debtors in contempt of court by reaching their ex-

amount of recovery and it may not make sense for these creditors to pursue it after the bankruptcy proceeding.

²⁰³ 478 US 421 (1986).

²⁰⁴ *Id.* at 443 (explaining that the purposes of civil contempt orders are to coerce compliance and to compensate for losses).

empt assets would deter the debtor from disobeying a court order, and would thus protect both creditors and court resources in the future.

Finally, allowing courts to issue sanctions where a debtor improperly conceals or retains nonexempt property provides legitimacy to the bankruptcy process. The bankruptcy system is based on the dual goals of providing debtors with a fresh start as well as distributing existing assets to creditors. If the public begins to doubt the reliability of the bankruptcy system, or if the system indicates a preference for debtors' rights over creditors', our system may suffer as a result. For example, if creditors fear that our bankruptcy system is weak or that it provides preferential treatment to individual debtors, they may be more hesitant to provide loans or financing to specific groups of individuals, particularly to vulnerable people in need of them.²⁰⁵

2. Allowing a surcharge does not conflict with the purposes or provisions of the Bankruptcy Code.

Allowing courts to reach a debtor's exempt assets as a consequence of disobeying a court order does not, as the *Scrivner* court claimed,²⁰⁶ violate other provisions of the Bankruptcy Code. The purpose of individual bankruptcies is to provide a fresh start to the "honest but unfortunate debtor."²⁰⁷ Exemption statutes are designed to further this purpose and allow debtors to proceed, after bankruptcy, unrestrained by their debt and with a sufficient quality of life. However, the Code is not fashioned to protect the dishonest debtor. By filing for bankruptcy, a debtor has acknowledged his troubled situation and asked the court system for assistance. The bankruptcy process is designed to assist both debtors and creditors, but the bankruptcy proceeding is contingent on the parties obeying court orders and acting in good faith. For example, in *Taylor*, the Supreme Court specifically noted that it must enforce the time limits contained in § 522(l) where the exemption list is "claimed in *good faith*."²⁰⁸ The Court's inclusion of the words "good faith" indicates that courts may only be required to enforce § 522(l) where the debtor claims exemptions in good faith, not where the debtor dishonestly claims exemptions and continues to con-

²⁰⁵ See Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 NC L Rev 75, 116–17 (1995) (explaining that a bankruptcy system that favors redistribution at the expense of efficiency would be borne heavily by the riskiest debtors who would no longer receive loans).

²⁰⁶ See Part II.B.

²⁰⁷ *Grogan v Garner*, 498 US 279, 286 (1991).

²⁰⁸ 503 US at 645 (emphasis added).

ceal nonexempt assets, knowing they are retaining more value than their exemption statutes permit.

Additionally, allowing courts to surcharge a debtor's exempt assets as a sanction for contempt does not reduce the value of that debtor's retained assets below his permitted exemptions—the surcharge therefore would not violate exemption statutes, regardless of whether federal or state law governs. For example, suppose a debtor is entitled to retain \$100 worth of exempt assets. After filing for bankruptcy, the debtor additionally uses \$50 of nonexempt assets that he concealed in an undisclosed account. If the court surcharges the debtor's exempt assets to account for that \$50, the debtor would still have received the full value permitted in the exemption statute after filing (\$100). The court is simply preventing the debtor from keeping more than is he is allowed; the extra \$50 rightfully belongs to the creditors. The surcharge thus compensates the creditor while still providing the debtor with the full value of permitted exemptions. Therefore, it furthers the Bankruptcy Code's purpose of collecting debt without restricting the debtor's ability to gain a fresh start.

Finally, as case law relating to other provisions of the Code demonstrates, a court does not necessarily defy the Code's boundaries by reaching property that the debtor claimed as exempt. First, in the setoff cases,²⁰⁹ the majority of courts allow creditors to setoff a debt, pursuant to § 553 of the Code, by acquiring the value of their debt from the debtor's exempt assets.²¹⁰ The courts recognize that this does not violate § 522(1) of the Code because the creditors had a right to the value of the debt before the debtor filed the list of exemptions, and the property was therefore not property of the estate. Additionally, courts may take exempt assets into consideration when sanctioning a debtor for contempt.²¹¹ In *Swanson*,²¹² the court in fact permitted the trustee to surcharge the debtor's exempt assets to account for the administrative expenses incurred as a result of the debtor's contemptuous conduct.²¹³ Therefore, since § 522(1) may only apply to exemption lists filed in good faith, and because courts have allowed creditors to use their contempt powers to reach exempt assets in particular situations, courts will not breach the Code by sanctioning debtors with a

²⁰⁹ See Part III.A.2 for a discussion of setoffs in bankruptcy.

²¹⁰ See, for example, *IRS v Luongo*, 259 F3d 323, 336 (5th Cir 2001) (holding that a setoff, which reaches property that would otherwise be exempt under applicable law, does not violate § 522 of the Code); *Gould*, 389 BR at 120 (same).

²¹¹ See Part III.B.3.

²¹² 207 BR at 80–81.

²¹³ See Part II.B.3.

surcharge on their exempt assets if the debtors still receive the full value of their permitted exemptions.

3. Limitations on the court's ability to surcharge exempt assets.

The courts that currently allow a creditor to surcharge a debtor's exempt assets do not follow a specific standard regarding when to surcharge the assets. For example, in *Latman*, the Ninth Circuit held that courts may use their equitable powers under § 105(a) to surcharge a debtor's exempt assets only in "exceptional circumstances."²¹⁴ However, the court failed to provide any further guidance to direct the courts. This Comment asserts that courts, in order to sanction a debtor by reaching his exempt assets, should be required to find that: (1) the debtor willfully violated a court order; (2) the debtor, after filing for bankruptcy, retained the full value of his permitted exemptions plus the undisclosed or improperly retained assets; and (3) the trustee was unable to reach the improperly retained estate property. By satisfying these minimum requirements, a court would recognize the limits of its contempt powers while simultaneously performing a remedial act in an equitable manner.

First, in order to surcharge a debtor's exempt assets, the court must find the debtor in contempt of a court order.²¹⁵ While courts impose various standards regarding a finding of contempt, with some offenses requiring knowledge and most others simply requiring a violation,²¹⁶ a willful violation test is more appropriate in these situations. Withdrawing assets from a debtor's exempt property is prohibited by the Code when the debtor creates the exemption list in good faith.²¹⁷ Therefore, in order to reach those exempt assets, the court should require proof that the debtor did not act in good faith—this entails proving that the debtor engaged in a knowledgeable violation of the court order to disclose or turn over estate property. The trustee should bear the burden of proving to the court, with clear and convincing evidence, that the debtor willfully violated the court order.²¹⁸ To satisfy this requirement, the trustee must first prove that the debtor knew that the court issued an order to either disclose or turn over nonexempt proper-

²¹⁴ 366 F3d at 786 ("Under exceptional circumstances, such as those presented here, surcharge may be the only means fairly to ensure that debtors retain their statutory 'fresh start,' while also permitting creditors access to property in excess of that which is properly exempted under the Bankruptcy Code.").

²¹⁵ Otherwise, the court would be creating a substantive right to surcharge which, as previously discussed, is beyond a court's power.

²¹⁶ See Part III.B.1.

²¹⁷ See Part III.A.

²¹⁸ See Part III.B.1.

ty. If the court finds that the debtor was aware of the court order, then the trustee also must prove that the debtor intentionally violated that order by concealing or failing to turn over the property.

If the court finds the debtor in contempt of a court order, then it should ensure that, at the time debtor filed for bankruptcy, he retained the full value of his exemption list in addition to the undisclosed assets. By requiring this element, the court can verify that the debtor retained his full statutory allowance and that the surcharge would simply prevent him from keeping *more* than his permitted exemptions. Otherwise, seizing money from a debtor's exemptions would violate both § 522 of the Code, which provides debtors with the right to exempt a certain amount of assets from their bankruptcy estate, and the idea of providing the debtor with a "fresh start."²¹⁹

Finally, the trustee should be required to prove to the court that he is not able to acquire the estate property in question. This surcharging remedy is meant to compensate an aggrieved creditor, and creditors should not be able to recover assets or the value of assets from a debtor's exempt property if the creditor is able to reach the nonexempt estate property. Otherwise, a creditor may attempt to use this remedy to circumvent the Code's provisions to acquire assets or cash that it otherwise would not be entitled to. For instance, if an automobile should be included in the estate, but the creditor would prefer to obtain an exempt piece of jewelry worth the same amount, the creditor should not be able to use this sanction to acquire the jewelry—the creditor should only be able to obtain the jewelry if he cannot recover the car. Therefore, before the court should sanction a debtor by surcharging his exempt property, the creditor should be obligated to prove to the court that it was not able to reach the nonexempt estate property.

CONCLUSION

In order to properly regulate bankruptcy proceedings while simultaneously providing debtors with a fresh start and fostering debt collection, bankruptcy courts must be authorized to enforce the provisions of the Bankruptcy Code. Congress recognized this necessity and provided the courts with a statutory grant of equitable power in § 105(a) of the Code. However, courts may not use these powers to create substantive rights and remedies, as § 105(a) is a procedural instrument meant to further specific provisions of the Bankruptcy Code.

²¹⁹ See Part III.A.

Courts therefore exceed their equitable powers by creating a substantive right to surcharge a debtor's exempt assets.

This Comment suggests, however, that if a debtor fraudulently conceals or refuses to turn over estate property, and the creditor is unable to subsequently reach the property, the court should be able to nonetheless force the debtor to give up his ill-gotten gains through its power of contempt and sanction him by surcharging his exempt assets for the value of the improperly retained property. As long as this contempt power is properly limited to only those circumstances where there is a willful violation, the debtor still receives the full value of his permitted exemptions, and the creditors are unable to reach the non-exempt assets, we should expect that courts like *Latman*, *Scrivner*, and *Mazon* will be able to incent the proper behavior by debtors without improperly utilizing § 105(a). This remedy allows the court to compensate the creditor, forces the debtor to obey the court order, and deters debtors from attempting to conceal or improperly retain estate property, while at the same time protecting and furthering the substantive provisions of the Bankruptcy Code.